Supreme Court of the United States

October Term, 1960

No.

MILWAUKEE & SUBURBAN TRANSPORT CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

CROSS PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Richard R. Theisen,
Robert Theisen,
W. W. Brewster,
Dale L. Sorden,
411 East Mason Street,
Milwaukee 2, Wisconsin,
Counsel for Petitioner.

A. C. [illegible],
[illegible], Wisconsin,
[illegible] Theisen,
[illegible], Illinois,
[illegible] Peterson,
[illegible], Illinois,
Of Counsel.

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vs.

COMMISSIONER OF INTERNAL REVENUE.

CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

This cross-petition for a writ of certiorari to review all of the judgment of the Court of Appeals for the Seventh Circuit is filed by the Milwaukee and Suburban Transport Corporation on condition that if the court grants the petition of the Commissioner of Internal Revenue in cause No. 843 for a writ of certiorari to review the accounting method issue as determined by the Seventh Circuit Court of Appeals, a writ of certiorari should also be granted to review the lower court's decision on the interest deduction issue. A conditional cross-petition for a writ of certiorari was recognized in *McComb* v. *Farmers Reservoir and Irrigation Company*, 335 U. S. 809, in which certiorari was granted. This petitioner has filed herewith a brief in opposition to the petition for a writ of certiorari in cause No. 843.

OPINIONS BELOW.

The opinion of the Tax Court is not reported. The opinion of the Court of Appeals is reported in 283 Fed. 2d 279. The opinion of the Tax Court and the opinion of the Court of Appeals are set forth in Appendix A to the petition of the Commissioner of Internal Revenue. The appendix used by the parties in the Seventh Circuit Court of Appeals has been filed by petitioner as the record in cause No. 843.

JURISDICTION.

The judgment of the Court of Appeals was entered on October 24, 1960 (Pet. App. A. pp. 60, 61). An extension was granted to the Commissioner to March 24, 1961, to file his petition for a writ of certiorari. The jurisdiction of this court is invoked under 28 U. S. C., Section 1254 (1).

QUESTIONS PRESENTED.

1. Whether petitioner can deduct as interest payments made on a preferred stock which has a fixed maturity date, which imposed a fixed obligation on petitioner to pay out of capital, if necessary, and which represented part of the unpaid balance of the price on assets purchased?

2. Whether the Federal Income Tax consequences of a security designated preferred stock by a state statute but which is in fact debt is to be controlled by state law or Federal law?

3. Whether a uniform standard in applying the Internal Revenue Code is to be used by the Federal courts in determining whether a particular security is in fact debt or equity for Federal Income Tax purposes?

STATUTES AND REGULATIONS INVOLVED.

The pertinent provisions of Section 23 of the Internal Revenue Code of 1939 and of Sections 162 and 163 of the Internal Revenue Code of 1954 and of Treasury Regulations 111 (1939 Code) and Regulations 1.163-1 (1954 Code) are reprinted in Appendix D, *infra*, pp. 11, 12.

STATEMENT.

Petitioner, Milwaukee and Suburban Transport Corporation, a Wisconsin corporation, was formed to purchase the assets of the Milwaukee mass transportation system from the Milwaukee Electric Railway and Transport Company (hereinafter called "seller"), which was a wholly owned subsidiary of Wisconsin Electric Power Company (hereinafter called "Electric Company"). The Tax Court found that the Electric Company was compelled to divest itself of this mass transportation system under the Federal Public Utility Holding Company Act (Rec. 256). The Electric Company had tried unsuccessfully for a number of years to sell the transit system subsequently purchased by petitioner at a price of $10,000,000. The sellers wanted cash (Rec. 48) but the petitioners could only raise $500,000. The seller was fearful that if all notes were taken, the securities would not be proportionate under the Wisconsin Statute (Rec. 41). The seller determined that $4,000,000 in first mortgage bonds would be sold to the public and the cash proceeds would be delivered to the seller (Rec. 40). The seller took back $3,000,000 in junior secured notes and $3,000,000 in preferred stock.

Despite the use of the preferred stock, the Wisconsin Commission found a disproportionate amount of securities senior to the common stock (Rec. 162). The statute is for the protection of purchasers of securities (Sec. 184.6 (1) (2) Wisconsin Statutes). To protect possible

purchasers of securities, the Wisconsin Commission froze both the junior notes and the preferred stock in the seller (Rec. 163) and thereby avoided the question of proportionate securities.

While the Tax Court held (Pet. App. A, page 27) (Rec. 271) that there was neither a fixed obligation to pay the preferred stock nor a fixed and definite maturity date, the Seventh Circuit Court of Appeals found (Pet. App. A, page 48) the preferred stock had a definite maturity date (March 1, 1972), that the redemption at maturity could be paid out of capital and was not dependent on earnings. The only restriction is that the corporation is not thereby rendered insolvent. The court further found that while current dividends are restricted to earnings (Pet. App. A, page 49), all deferred cumulative dividends were found to be payable out of capital surplus at redemption time. (Such accumulated dividends were equally payable out of capital regardless of surplus the same as the principal amount of the preferred stock.)

Seller's own witness Seybold admitted that the seller could not take ordinary preferred stock without this special redemption provision because that would be ownership (Rec. 44). He testified (Rec. 43) that seller believed it was getting preferred stock having "* * * the general attributes of such a stock, together with a special redemption provision * * *." Petitioner's witness Coleman's uncontradicted testimony (Rec. 71) was that the preferred stock was intended as debt for the unpaid purchase price.

The government, in a collateral income tax proceeding involving this seller, admitted in a written report that the preferred stock represented a definite and fixed obligation to pay the full face amount of this security at maturity (Rec. 238A). The Tax Court refused to receive

this admission by the government into evidence (Rec. 255) on the grounds that this admission was a conclusion of the party (Rec. 245, 246, 248 and 249).

The S. E. C., specifically noting the fixed retirement provisions (Rec. 142), approved the transaction as a plan of divestment of ownership by the seller. The Wisconsin Commission, as appears from its opinion (Rec. 156), was fully apprised of the facts, including the tax benefit to the seller of $4,500,000 (Rec. 158) and the preferred stock redemption provisions (Rec. 161, 162). The Commission's security expert, Mr. Colbert, was objecting to the approval of the transaction in part because of the contractual sinking funds on the preferred stock (Rec. 25).

Because of the large depreciation accrual for regulatory purposes (Rec. 181), by March of 1958, or slightly more than five years after the purchase, $4,826,334 of the $10,000,000 twenty-year obligation was paid off.

Petitioner, on its tax returns for the years 1953 and 1954, deducted as interest the amount of its payments with respect to the preferred stock, which payments were disallowed as deductions by the Commissioner. As indicated by the Tax Court (Rec. 269), the ultimate question is whether petitioner will be allowed an interest deduction or whether the seller will receive an equivalent dividend received credit. Seller's returns are being held open (Rec. 47).

REASONS FOR GRANTING THE WRIT.

1. Petitioner believes that the decision below is in conflict with other Circuit Courts of Appeal and is erroneous. The court, after finding the so-called preferred stock was a fixed obligation having a fixed maturity date, payable out of capital if necessary, and representing the unpaid balance of a purchase price in a bona fide arm's

length transaction, then in effect held that it was not an obligation but only an equity investment. (Under Wisconsin law, such a contract to redeem is enforceable out of capital by court action. *Strait v. Northwestern Steel and Iron Works* (1912), 148 Wis. 254.) A true preferred stockholder, like a common stockholder, has an investment which is frozen as compared with the creditor who has a right at some time to demand payment of his debt. Redemptions of true preferred stock are at the option of the corporation and not the holder as is true in this case. The confusion in the law on this subject is demonstrated by *John Kelley Co.* v. *Commissioner*, 326 U. S. 521, 90 Law Ed. 278, where Justice Rutledge (page 531) in dissenting, found that the two cases there considered involved identical facts situations yet opposite results were reached. The *Kelley* case is the only case heard by this court on this point. The case was decided by this court on the proposition that judicial review of the Tax Court was limited to legal questions. (The scope of judicial review was subsequently enlarged by the second session of the 80th Congress to include review of all questions to the same extent as decisions of district courts in civil actions tried without a jury. I. R. C. (1939), Section 1141 (a), re-enacted I. R. C. (1954) Section 7482.) The court, in holding that a fixed obligation was nonetheless equity, is in conflict with other courts of appeal. *Commissioner* v. *O. P. P. Holding Corp.* (C. A. 2), 76 Fed. 2d 11, page 12; *Commissioner* v. *Palmer. Stacy-Merrill* (C. A. 9), 111 Fed. 2d 809; *Commissioner* v. *Proctor Shop, Inc.* (C. A. 9), 82 Fed. 2d 792; *Gilbert* v. *Commissioner* (C. A. 2, 1957), 248 Fed. 2d 399, 402; *U. S.* v. *South Georgia Railroad Company* (C. A. 5, 1939), 107 Fed. 2d 3, at page 5; *Washmont Corporation* v. *Hendricksen* (C. A. 9), 137 Fed. 2d 306, at page 308.

2. The decision below, in contending that the test is whether the preferred stock was "subject to the risks of

the venture," ignores the fact that all debts are exposed to the risks of the venture. If measured by the risk, common stock in a strong corporation would have less risk than a first mortgage debt in a failing company. The other reason advanced, viz., that the security was called preferred stock, seems to be the actual basis for the decision. The question then is: Are these cases to be decided by labels even though an obligation to pay is present? Using the label as a criterion for determination, conflicts with the many cases holding that substance and not labels control. *Helvering* v. *Lazarus Company*, 308 U. S. 252, page 255; *Moore* v. *Commissioner* (C. A. 7), 124 Fed. 2d 991, at page 993; *Oesterreich* v. *Commissioner* (C. A. 9), 226 Fed. 2d 798, at page 801. In *Watson* v. *Commissioner* (C. A. 9), 62 Fed. 2d 35, it was held that the designation and interpretation of an agreement by a state regulatory commission should be ignored in interpreting Federal Income Tax laws. More important, if the label supplied by state statute is controlling, Federal Income Tax consequences will depend on state law contrary to the many cases holding that while state law determines the rights of the parties, income tax consequences are purely a federal question. *Burnet* v. *Harmel* (1932), 287 U. S. 103, 110; *Putnam Est.* v. *Commissioner*, 324 U. S. 393; *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110; *Lucas* v. *Earl*, 281 U. S. 111; *Helvering* v. *Clifford*, 309 U. S. 331; *Commissioner* v. *Tower*, 327 U. S. 280; Compare *U. S.* v. *Kintner* (C. A. 9, 1954), 216 Fed. 2d 418, holding a group of physicians were a corporation even though under state law such a corporation would be unlawful.

3. The court's statement below that because insolvency would prevent collection, the preferred stock is subordinate to other creditors and inferentially is not a debt, is in conflict with the cases holding subordination of a debt,

and even complete inability to pay does not destroy the debt. *Keebey's, Inc.* v. *Paschal* (C. A. 8, 1951), 188 Fed. 2d 113; *Commissioner* v. *H. P. Hood and Sons, Inc.* (C. A. 1), 141 Fed. 2d 467, at page 470; *Commissioner* v. *Proctor Shop, Inc.* (C. A. 9, 1936), 82 Fed. 2d 792, where the creditors ranked ahead of the preferred stock (page 793); *Commissioner* v. *Page Oil Co.*, 129 Fed. 2d 748.

4. The court's reliance on the fact that current dividends could only be paid out of earnings although at redemption time all deferred dividends had to be paid out of capital if necessary is in conflict with the cases holding that the yield on a debt can be deferred providing the yield must in all events be paid on a date certain. *Commissioner* v. *H. P. Hood and Sons* (C. A. 1), 141 Fed. 2d 467, page 470; *Commissioner* v. *O. P. P. Holding Corporation* (C. A. 2), 76 Fed. 2d 11, at page 12.

5. The decision below is in conflict with cases holding that if for reasons personal to the parties a debt is cast as preferred stock, it is still a debt. *U. S.* v. *Title Guarantee & Trust Co.* (C. A. 6), 133 Fed. 2d 990; *Arthur R. Jones Syndicate* v. *Commissioner* (C. A. 7), 23 Fed. 2d 833; *Commissioner* v. *Proctor Shop, Inc.* (C. A. 9), 82 Fed. 2d 792; *Commissioner* v. *Palmer, Stacy-Merrill* (C. A. 9), 111 Fed. 2d 809.

CONCLUSION.

Examination of the innumerable cases on this subject will demonstrate that there are no standards to be used other than costly litigation to determine the problem here involved. If the label used is determinative of the question, the income tax consequences will be controlled by state rather than Federal law. Because of the obvious conflict of the decision of the court below with numerous other decisions of the various circuit courts of appeal, this case merits review.

Respectfully submitted,

RICHARD R. TESCHNER,
ROBERT THORSEN,
W. W. BROWNING,
DALE L. SORDEN,
Attorneys for Petitioner.

April 1961.

APPENDIX D.

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

Treasury Regulations 111 (1939 Code):

SEC. 29.23 (b)-1. INTEREST. Interest paid or accrued within the year on indebtedness may be deducted from gross income * * *

* * * * *

* * * So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. * * *

Internal Revenue Code of 1954:

SEC. 162: *Trade or Business Expenses.* (a) *In General*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

Internal Revenue Code of 1954:

SEC. 163 (a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Treasury Regulations

Sec. 1.163-1 (1954 Code):

Interest Deduction in General. **(a) Except as otherwise provided in sections 264-267, inclusive, interest paid or accrued within the taxable year on indebtedness shall be allowed as a deduction in computing taxable income.**

* * * * * *

(c) * * * So-called interest on preferred stock which is in reality a dividend thereon, cannot be deducted in computing taxable income. * * *

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No. 928

In the Supreme Court of the United States

OCTOBER TERM, 1960

MILWAUKEE & SUBURBAN TRANSPORT CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON CROSS PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE COMMISSIONER OF INTERNAL REVENUE IN OPPOSITION

ARCHIBALD COX,
Solicitor General,
Department of Justice,
Washington 25, D. C.

In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 928

MILWAUKEE & SUBURBAN TRANSPORT CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON CROSS PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE COMMISSIONER OF INTERNAL REVENUE IN OPPOSITION

We respectfully invite the attention of the Court to the following facts, which show that the cross petition was filed out of time:

The judgment of the Court of Appeals was entered on October 24, 1960. The cross petition was not received for filing in this Court until April 26, 1961, 184 days subsequent to the entry to judgment. Petitioner sought no extension of time, and its cross petition was in any event filed beyond the time which

would have been available to it if the maximum extension of sixty days had been applied for and granted.* It seems plain, therefore, that the cross petition should be denied or dismissed for failure to file within the time specified by 28 U.S.C. 2101(c).

Respectfully submitted,

ARCHIBALD COX,
Solicitor General.

MAY, 1961.

* The Commissioner lost, in the court below, on an issue discrete from those which Milwaukee & Suburban seeks to raise. Upon timely application by the Commissioner, the time within which to petition for a writ of certiorari was extended, by order of Mr. Justice Clark, to and including March 24, 1961. The Commissioner's petition, which is now pending (No. 843, this Term), was filed on March 23, 1961.

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Supreme Court of the United States

No. 928

REPLY MEMORANDUM OF MILWAUKEE & SUBURBAN TRANSPORT CORPORATION CROSS PETITIONER

IN THE

Supreme Court of the United States

OCTOBER TERM, 1960.

No. 928.

MILWAUKEE & SUBURBAN TRANSPORT CORPORATION,

Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE.

REPLY MEMORANDUM OF MILWAUKEE & SUBURBAN TRANSPORT CORPORATION, CROSS-PETITIONER.

There is no dispute that this cross-petition was not filed within the time allowed for filing an original petition for certiorari. The question is whether this is necessary. If so, the filing of a cross-petition would be impossible in most cases, including this one.

The point raised by the government's memorandum involves a question of practice and not of jurisdiction. This court not only has the power to accept this cross-petition, but even in the absence of a cross-petition, has the right in its discretion to consider points not raised by the petition for certiorari. *Langnes* v. *Green*, 282 U. S. 531, 538, 75 L. Ed. 520, 525.

The cross-petition and cross-appeal are highly beneficial in reducing the number of appeals. With such proce-

dure available, the partially successful party in the lower court in many cases will not hazard his partial victory by initiating review. If the government's position is sustained, such partially successful party must anticipate the appeal of his adversary and to protect himself must unnecessarily burden the court by filing an original petition for certiorari.

The rules of this court recognize and sanction a cross-petition. Paragraph 5 of Rule 21 provides for the record to be filed on a cross-petition and Paragraph 6 of the same rule states:

> "6. Any respondent, including a cross-petitioner, *may, within the time allowed for filing his brief in opposition or his cross-petition*, file duly certified portions of the record additional to those filed by the petitioner." (Italics ours.)

The government's contention would effectively destroy the cross-petition. Counsel for this petitioner in October of 1960 advised the Attorney General's office that if a petition for certiorari were filed in this court, this petitioner would file a cross-petition. The ninety-day period for a petition for certiorari in this case expired on January 23, 1961. On January 18, 1961, without notice to petitioner, an extension of time was granted to the Solicitor General to file the government's petition for certiorari to and including March 24, 1961; however, this petitioner had no knowledge of this action until receipt of a letter of January 24, 1961, from the office of the Solicitor General dated January 23, 1961. No bad faith is claimed by petitioner but the above facts demonstrate that a cross-petition could not have been filed on the facts in this case if the government's contention is sustained.

Under the government's contention, cross-petition for certiorari is a complete misnomer. If the cross-petition must be filed within the original time allowed for filing a

petition for certiorari, it would be as much an original petition as the opponent's petition. The words cross-petition or cross-appeal presume that a petition or an appeal has been filed. Further, the conditional cross-petition which was filed by this petitioner and which was approved in *McComb* v. *Farmers Reservoir and Irrigation Co.*, 335 U. S. 809, would be abrogated except where the original petition is filed well in advance of the ninety-day period allowed for certiorari.

Both Wisconsin, where the trial was held, and Illinois, where the 7th Circuit reviewed this decision, allow a reasonable time for a cross-appeal.[1]

Petitioner submits that Paragraph 6 of Rule 21 should be read as granting a respondent time to file a cross-petition within the time allowed for filing the respondent's brief. Otherwise, this beneficial procedural device specifically provided for by the rules of this court would be destroyed by the simple maneuver of filing a petition for certiorari so near the end of the ninety-day period that it is impossible to file a cross-petition.

This is not a case where petitioner has been negligent or derelict such as in *Grigsby* v. *Purcell*, 99 U. S. 505; 25 L. Ed. 354, or *Winslow* v. *Wilcox*, 105 U. S. 447; 26 L. Ed. 1065, where years elapsed after the time had expired before the cross-appellant attempted to perfect their appeals. Here, petitioner filed its cross-petition at the first opportunity to do so and within the time allowed for its brief.

Petitioner is unable to find any authority denying the right to file such cross-petition on the facts in this case where the petitioner has diligently prosecuted its cross-petition. 28 U. S. C. 2101 (c) cited by the Solicitor General does not sustain the government's position because

1. Wisconsin Statutes 1959, Sec. 274.12; Illinois Revised Statutes 1959, Chapter 110, Sec. 101.35 (Supreme Court Rule 35).

it does not refer to cross-petitions for certiorari and because the "judgment or decree in a civil action" is already in the process of being brought before this court by the government's petition for certiorari.

The necessary copies of the cross-petition were shipped by Gunthorp-Warren Printing Company from Chicago on April 19, 1961, but, through inadvertence, the docket fee was not included. Upon discovering this oversight, a check was forwarded in payment of the docket fee. The conditional cross-petition was received by the Clerk well within the time allowed by the rules to file a response to the petition for certiorari.

As shown above, the rules seem to contemplate that a respondent to a petition for certiorari shall have time (i.e. 30 days) to respond to the petition by a brief in opposition or a cross-petition, or both. Unless the respondent has the same time in which to file a cross-petition as it has for filing a brief in opposition, the rule provisions granting the right to file a cross-petition are meaningless.

It is respectfully submitted that the conditional cross-petition was filed in apt time in accordance with the rules of this Court.

Respectfully submitted,

RICHARD R. TESCHNER,
ROBERT THORSEN,
W. W. BROWNING,
DALE L. SORDEN,
Attorneys for Petitioner.

May, 1961.